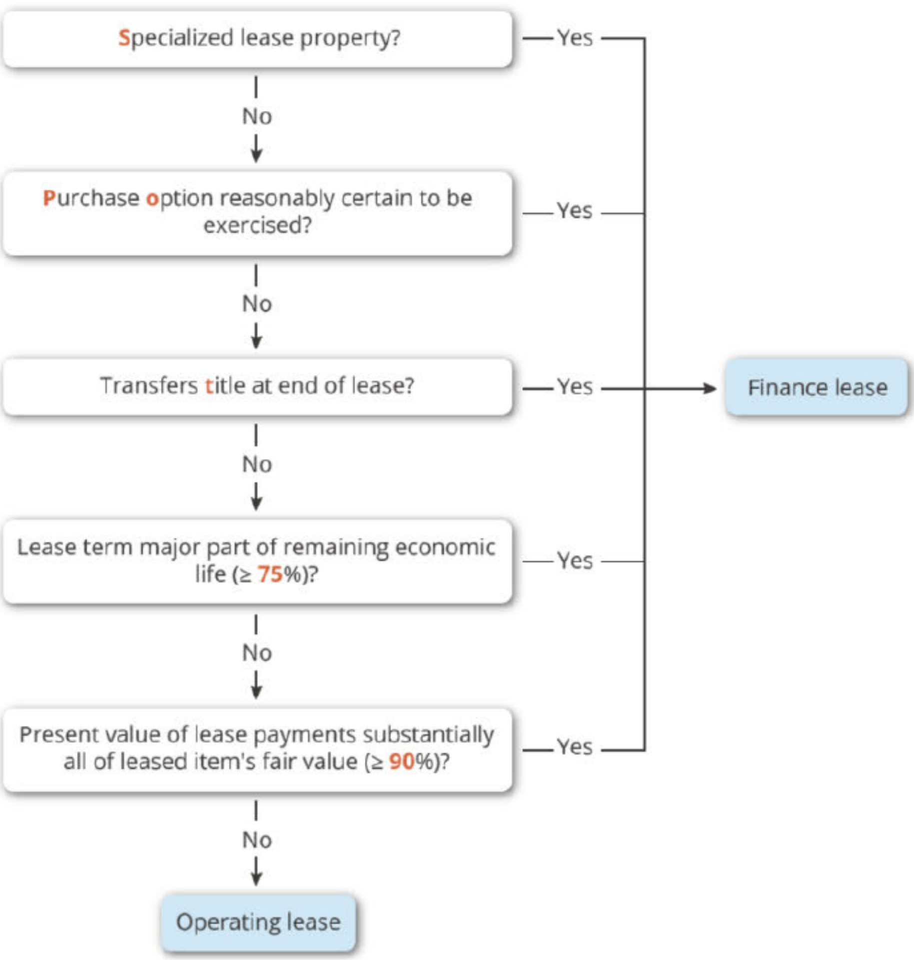
11.04 Sales Type Leases – Lessor Accounting

Overview

If a lease meets one of the five criteria as a finance lease (ie, Special-PO-T-75-90), the lease is accounted for by the lessor as a sales-type lease, either with or without profit. Some nonoperating leases can also be classified as direct financing leases when they don't meet any of the finance lease criteria, but this is a rare type of lease.



Recognition

At the commencement date, the lessor must:

- **Derecognize the leased asset** (so long as collectability of lease payments is probable)
- **Recognize:**

- Net investment in the lease, which includes:
  - *Lease Receivable*, measured at PV of future lease payments and any amount expected from a residual value guarantee.
  - *Unguaranteed Residual Asset*, measured at PV.
- Selling profit or loss =
  - Fair value of asset (or, if lower, Lease Receivable + Prepaid Lease Payments)
  - Less: Carrying amount of asset net of unguaranteed residual asset
  - Less: Deferred initial direct costs
- Initial direct costs, which are either:
  - *Expensed immediately* when the lease includes a selling profit, or
  - *Deferred over the lease term* as an increase in Lease Receivable and decrease in overall Interest Revenue when there is no selling profit.

After the commencement date, the lessor must recognize:

- **Interest income** on the net investment in the lease
- **Variable lease payments** (that are not already included in the Lease Receivable) in the period in which the circumstances that fix the payments occur
- **Credit losses** on the net investment in the lease

Sales-Type Lease with Selling Profit

This is a lease in which the seller is usually a manufacturer or dealer of the asset and uses the lease as a way of selling the asset on an installment basis. The fair value of the leased property differs from the cost, which creates a dealer's profit or loss. Let's take a look at how that last finance lease example would look from the lessor's perspective.

Assume the lessor has leased equipment to a lessee with the following terms:

- 8 years with payments of $75,000 per year, due at the beginning of the year.
- The estimated economic life of the equipment is 10 years.
- Title to the equipment passes at the end of the lease
- There is no residual value.
- The rate implicit in the lease is 11%.
- The lessor's cost of the equipment is $300,000.

Since the 1st payment of $75,000 is due on day 1 (ie, annuity due), the PV of the 8 lease payments at 11% (5.7122 PV factor) = $428,415.

Lease Liability	Interest Rate	=	Interest Expense	–	Lease Payment	=	Reduction in Lease Liability
428,415					75,000		75,000
(75,000)							
353,415	11%	=	38,876	–	75,000	=	36,124

(36,124)								
317,291	11%	=	34,902	–	75,000	=	40,098	
(40,098)								
277,193								

Initial entry to remove the asset from the books and record the Lease Receivable at PV of lease payments (note that there are no other payments, initial direct costs, or residual value in this example):

Lease Receivable	428,415	
Equipment		300,000
Gain on Sale		128,415

Or if the lessor is a merchant/dealer:

Lease Receivable	428,415	
COGS	300,000	
Inventory		300,000
Sales Revenue		428,415

First Payment at 1/1/Year 1:

Cash	75,000	
Lease Receivable		75,000

At the 12/31/Year 1, interest income is recognized, but the payment hasn't been received yet:

Interest Receivable	38,876	
Interest Revenue [11% × ($428,415 – 75,000)]		38,876

Second Payment at 1/1/Year 2:

Cash	75,000	
Lease Receivable		36,124
Interest Receivable		38,876

Sales-Type Lease without Selling Profit

This is a lease in which the lessor is **financing** the **acquisition** of an asset by the lessee but is **not earning a profit**. (This commonly happens when the lessor is a financial intermediary whose business model hinges on earning interest revenue.) The **PV** of the **lease payments** will be equal to the **fair value** of the property, and the lessor will earn only interest income. This makes our example a little simpler, since there is no profit, COGS, or Inventory to account for.

Assume the same facts as the last example, except that the lessor's cost of the equipment is $428,415 (ie, equal to the PV of the lease payments). Only the initial entry is different here since there is no profit to recognize; the rest of the entries are the same.

Initial entry to remove the asset from the books and record the Lease Receivable at PV of lease payments:

Lease Receivable	428,415	
Equipment		428,415

Direct-Financing Lease

This is a lease in which the lessor is **financing** the **acquisition** of an asset by the lessee but is generally **not earning** a manufacturer's or dealer's **profit**. The PV of lease payments will be equal to the fair value of the property, and the lessor will earn only interest income. A direct financing lease is a rare situation in which none of the five criteria (ie, Special-PO-T-75-90) are met, but it's also not an operating lease since:

- Collectability of the lease payments is probable, and
- There is a **residual value guaranteed by a compensated third party** (eg, an insurance company), and the combined PV of the following constitute *substantially all* the leased asset's fair value:
  - The lessee's lease payments
  - The lessee's guaranteed residual value
  - The third party's guaranteed residual value

The accounting for a direct financing lease is generally similar to a sales-type lease without selling profit, but in cases where there is a selling profit, the accounting varies a little: instead of immediately recognizing the selling profit, it is *deferred and recognized as interest income when payments are received*. This is accomplished by reducing the Lease Receivable with a contra asset credit entry to **Deferred Profit**.

Due to the rare nature of this type of lease, it is unlikely to be tested to a depth beyond remembering and understanding how such a lease is classified.

Testable as of 4/1/2022: When the exclusion of certain variable payments (as previously mentioned) from the lease receivable will result in a loss on the commencement of a **sales-type** or **direct-financing lease**, such leases should instead be **classified** as an **operating lease**.